EPFSF Lunch Discussion

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"The new Basel capital requirements: pros and cons"

Speech from Andrew Cross
Managing Director, Risk Measurement and Management, Credit Suisse

The Patient is sick with more than one illness,
lets not kill it with the cure.

Welcome

Mrs Chairwoman
Members of the European Parliament
Ladies and Gentlemen:

Introduction

Thank-you very much for giving me the opportunity to speak to you today on the new capital rules. I think in many ways the title of today's lunch understates the importance of what we are addressing. The set of proposals announced by the Basel Committee in 2009, in July and December, combined with upcoming initiatives from the FSB targeted at systemically relevant institutions really constitute the most fundamental resetting of bank prudential standards in a generation. That does not mean we are on the wrong course or that many of the changes themselves are not well crafted, more the point is that the cumulative impact is what matters.

I have spent a most of my career in a large banking group both as a risk manager and also as a translator of regulatory change initiatives into operational reality. Given this hopefully I can share some insights from the "sharp end" where regulatory change is turned into reality. Specifically how does regulation impact the practice of good risk management and how do banks of all sizes react to increased constraints.

Needless to say finely crafted regulatory rules with good intentions can often have some perverse outcomes so understanding how institutions will react to the changes in some ways are just as important as the design of the changes themselves.

Key points:

Overall

- Scale, range and complexity of the changes is very large – not in itself a bad thing or inappropriate given the crisis we have been thought, nevertheless the cumulative impact of proposed changes are hard to estimate so the implementation timeline and mechanisms need more attention

- Constraints/calibration – these will be the real drivers of the outcomes from the changes proposed and at the institution level strategy will be driven by overall constraints such as a new capital ratio target, new leverage ratio and new liquidity metrics

    - so get the leverage ratio wrong and you will drive banks away from low risk lending that generates a poor return on balance sheet usage metric

    - similarly tighten the dial too much on liquidity and banks will be driven away from "illiquid" medium term lending that is constrained under the new 1 yr liquidity metric

- to be clear, constraints themselves are an existing and necessary part of having a resilient banking sector and can be used very effectively to drive certain behaviours
- For example, the proposals around derivatives positively drive the industry towards using central counterparties, which with the right resilience planning for these CCPs should materially reduce operational risk in the industry

- Impact analysis – this is the most vital part of what happens now;

  - The current plan around the Quantitative Impact Analysis (the so called "QIS") is a necessary but by no means sufficient process to estimate how these changes will impact the banking industry

  - Previous experiences with QIS exercises have had very mixed success predicting even approximately what will happen – given the scale of the changes planned here we would all do well to question how the impact analysis can be more holistic

  - For me the missing ingredient is a realistic assessment of bank behaviour – the QIS exercise is a huge process running to several hundred pages of analysis, though no where does it ask the fundamental questions "what is your bank likely to do in response to these change?"

  - Really the QIS should be the start of the impact assessment, proper assessment of the capital, liquidity and profitability consequences can only be achieved by understanding how bank managements will respond – and just to be clear, they wont all behave in the same way

- Timing – the current timetable is challenging as effectively banks have to assume that all the changes proposed in December will be enacted even though the final form of the package wont be finalised for many months yet

  - More pointedly I think within the EU a more realistic timetable needs to be put in place, otherwise there is a material risk of making fundamental change to the EU banking landscape without proper impact assessment or time for parliamentary scrutiny

Now, lets get practical about what is in flight and what should be on your issue lists with respect to the forward calendar

Content

CRD 2 ("aperitif")

- Topics: Large Exposures, hybrid capital and securitisation
- Really hang over from Basel II plus old priorities
- This goes live this year and the industry is well placed to meet the new standards

CRD 3 ("starter")

- Topics: driven mainly around the trading book changes proposed in the July 2009 Basel Committee package
- This aims to address a fundamental learning point from the existing capital regime that the trading book was undercapitalised
- Specifically the proposals look to enhance the Value-at-Risk (VaR) model regime with additional charges for stressed environments ("Stressed VaR") and default risk on trading book assets – the so called Incremental Risk charge ("IRC")
- What's interesting about this package of changes is that it really gives a test case of how banks and the market will react to material change in capital constraints
- The current timing is that this should go live this year, though that looks increasing unrealistic in the EU given we have only recently had the 1st exchange of views

- I encourage MEPs to review the timetable and impact assessment processes for CRD3 to see if we can shape a better way forward for CRD4 which addresses the Basel December package CRD 4 ("Main course")
- Capital constituents – removal of hybrids, focus on core capital
- Capital levels
- RWA for cpty risk incl CVA
- Leverage limits
- Liquidity

Final thoughts

One topic I haven't mentioned yet and is often bandied around as a goal/issue/problem with regulatory change is "Level Playing Field. My thoughts here are 2 fold:

- Recent experience has not been encouraging
    - The US is still not on Basel II
    - There is still a propensity for different EU states to adapt, either formally or more informally how regulation impacts their national institutions

- Practical solutions
    - Better peer review within EU and internationally on implementation
    - True test of equivalence for non EU parented organisations
    - Open disclosures of laggards and special deals

Thank-you very much for listening to my views on these key changes, hopefully I have stimulated some new lines of enquiry or perspectives on what can seem a very technical topic.

I look forward to your questions and points on these topics.